No. 20,897

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

LEONARD LUNDGREN and EVELYN R. LUNDGREN,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 37-54) 1/ were not officially reported.

JURISDICTION

The petition for review (I-R. 56-58) involves federal income taxes for the taxable year 1961. On September 25, 1963, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency, asserting a deficiency in income tax in the amount of $25,040.01. (I-R. 7.) Within ninety days thereafter, on December 22, 1963, the taxpayer filed a petition with the Tax Court for a redetermination of this deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-11.) The decision of the Tax Court was entered on January 10, 1966. (I-R. 55.) The

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1/ "I-R." and "II-R." references are to volumes I and II of the record on appeal.

case is brought to this Court by a petition for review filed January 19, 1966 (I-R. 56), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the Tax Court correctly found that the advances, totalling $129,000, made by the taxpayer to his closely held corporation (RushMore) did not qualify for a deduction under Section 166(a) of the Internal Revenue Code of 1954 since the advances were not debts created or acquired in connection with a trade or business, and were only partially worthless during the taxable year in issue.

STATUTE INVOLVED

Internal Revenue Code of 1954:

SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * *

(d) Nonbusiness debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

*   *   *

(26 U.S.C. 1964 ed., Sec. 166.)

STATEMENT

The facts as found by the Tax Court not being subject to any material dispute, may be briefly stated as follows:

Leonard Lundgren, hereafter referred to as taxpayer, and Evelyn R. Lundgren are husband and wife residing in the State of Oregon. (I-R. 38.)

Taxpayer has been engaged in the timber and lumber manufacturing business during his adult life and conducted this business through individual proprietorships and partnerships. He has organized various timber and lumber businesses, has been, and now is an officer thereof, and now holds substantial stock holdings in corporations engaged in the timber and lumber manufacturing and sales business. (I-R. 38.)

Prior to October 1, 1951, taxpayer conducted a lumber manufacturing and sales business as a sole proprietorship in and around Bend, Oregon. Taxpayer purchased a portable sawmill, for use in this business in 1947 at a cost of $31,366.65. (I-R. 46.)

On October 1, 1951, this business was taken over by the Leonard Lundgren Lumber Company, a partnership (hereafter referred to as the partnership"), the partners of which were taxpayer, Raymond B. Lundgren, and Orville A. Young. (I-R. 39,46.) The partnership took over the assets of the proprietorship at their adjusted basis; the adjusted basis of the portable sawmill was $14,738.77. 2/ The initial net worth of the partnership, reflecting the adjusted bases of the assets at October 1, 1951, was $210,628.04. Taxpayer had a seventy percent interest in the partnership, Raymond Lundgren had a twenty percent interest, and Orville Young had a ten percent interest therein. (I-R. 46.) The partnership was primarily engaged in the lumber and ranching business. (I-R. 39.)

Lundgren Sales Corporation, hereafter referred to as Sales, was formed in 1952 by taxpayer and his wife. All the stock of Sales has been and is held by them. Sales sold lumber produced by the partnership until 1956 and thereafter sold lumber produced by another corporation owned by taxpayer. (I-R. 46.)

In 1953, taxpayer organized a sole proprietorship to operate as a sawmill at Sisters, Oregon. This business, hereafter referred to as Sisters, sawed logs for the partnership until about March of 1956. The amount received by Sisters for work it performed was based upon a specified amount per thousand board feet of lumber manufactured, with an annual maximum. (I-R. 46-47.)

2/ This figure represents the difference between the cost of $34,743.65, less depreciation of $20,004.88. (I-R. 46.)

During the early part of 1956, the partners decided to reorganize the partnership. 3/ By an agreement dated February 15, 1956, the taxpayer, Raymond Lundgren, and Young caused the organization and incorporation of the RushMore Lumber Company, hereafter referred to as RushMore. RushMore was organized under the laws of South Dakota, for the purpose of setting up a sawmill operation in South Dakata. (I-R. 38-39.) On March 7, 1956, the partners formed Lelco, Inc., under the laws of Oregon. RushMore had an authorized capital of $250,000 and paid-in capital of $124,500. Lelco had an authorized capital of $500,000 fully paid-in. (I-R. 22, 38-39; Ex. 5-E.)

Under the plan to reorganize the partnership, a major portion of its assets subject to all liabilities were transferred to Lelco. The balance of the assets were transferred to RushMore and the partnership was terminated. (I-R. 39.)

The February 15th agreement specified that the assets tranferred to RushMore had a value of $100,000 and that the partners would receive $100,000 of capital stock, par value $1, in proportion to their respective partnership interests. (I-R. 39.) The following table shows the assets transferred to RushMore and their respective values (I-R. 40):

ASSETS	ADJUSTED BASIS TO PARTNERSHIP	ASSIGNED VALUE
Portable sawmill consisting of sawmill and lumber rolls, portable welder, small motor, edger and saw type M-330 (edger motor No. 6001) and G.M. C. diesel	$1,996.43	$86,900.00

3/ Sometime prior to 1956, taxpayer learned of certain timber in South Dakota which the Federal Government was going to sell. (I-R. 22; Ex. 5-E.)

ASSETS	ADJUSTED BASIS TO PARTNERSHIP	ASSIGNED VALUE
Loraine Moto Crane	$4,574.70	$10,000.00
1936 Chevrolet express	12.87	100.00
1951 Hyster lift truck RT-150-23785	1,600.00	3,000.00
Totals	$8,184.00	$100,000.00

Immediately after accepting transfer of the assets in exchange for the $100,000 of capital stock, RushMore received an additional $25,000 in cash for the sale of 25,000 shares of its stock. Such stock was purchased as follows (I-R. 41):

	Cost	Shares
Evelyn R. Lundgren	$4,500	4,500
Orville A. Young	1,000	1,000
Other individuals not related to taxpayers	19,500	19,500
	$25,000	25,000

Accordingly, capital stock, in RushMore was owned as follows (I-R. 41):

	No. of Shares	Percentage of Ownership
Leonard & Evelyn Lundgren	74,500	59.6
Raymond B. Lundgren	20,000	16.0
Orville A. Young	11,000	8.8
Other individuals not related to taxpayers 4/	19,500	15.6
	125,000	100.00

4/ In 1959, RushMore acquired 9,000 shares of stock from certain of these individuals at the par value in exchange for the corporation's promissory notes. These notes were not paid and are still outstanding. Other than this, there has been no change in stock ownership since 1956. Such acquisition of the 9,000 shares increased the percentage interest of taxpayers to 65.35 percent. (I-R. 41.)

Pursuant to the authorization by its board of directors, RushMore applied to the United States National Bank of Portland, Oregon, for a loan of $250,000. This loan application was rejected by the bank. (I-R. 41.)

Thereafter, RushMore applied to the Small Business Administration, hereafter referred to as SBA, for a loan of $250,000. As a part of the application taxpayer, as president of RushMore, represented that no lending institution would participate with the SBA in making the loan. Taxpayer further represented that there were no present plans for compensation of the officers or directors of RushMore. (I-R. 41-42.) Appended to and forming a part of the application were various memoranda and financial statements. Among these was a letter dated July 20, 1956, from taxpayer and addressed to RushMore stating that he held two Government contracts for the purchase of timber in South Dakota covering approximately 28,000,000 feet of stumpage and stating that this stumpage would be made available to RushMore if and when needed. (I-R. 22-23; Ex. 6 attached to Ex. 5-E.)

On August 31, 1956, SBA approved the loan application and authorized a loan of $250,000 with interest at six percent. (I-R. 42.) The loan authorization contained a number of conditions and numerous documents were required. (I-R. 25-27, 42.) Prior to the actual disbursing of those funds these conditions were met as follows (I-R. 25-27, 42-44):

1. Taxpayer personally guaranteed the $250,000 loan.
2. Taxpayer gave a mortgage on his mill at Sisters, Oregon, to secure performance of his guaranty.

3. Taxpayer agreed to advance to RushMore, subsequent to June 30, 1956, not less than $115,859 plus any amount by which the acquisition costs of the fixed assets for RushMore's sawmill facilities exceeded $473,738. (This was in addition to $29,000 taxpayer had already advanced to it).
4. Between June 30, 1956, and September 25, 1956, taxpayer advanced it cash in the amount of $64,500. This was in addition to the $29,000 taxpayer had already advanced prior to June 30, 1956.
5. Lelco supplied goods and services to RushMore which account or debt was purchased by taxpayer. This amounted to $43,291.32. In addition Lelcos' travel advance to RushMore of $808.44 was also acquired by taxpayer.
6. Sales advanced $2,634.29 to RushMore which was also acquired by taxpayer.
7. Taxpayer caused a life insurance policy on his life to be assigned to SBA. Taxpayer paid a premium on this policy of $4,734.50.
8. The advances by taxpayer were the subject of nineteen unsecured demand promissory notes with interest at four percent. Taxpayer, by standby agreement, agreed not to take any action to collect these notes, and further agreed that in case of bankruptcy, receivership, dissolution or liquidation

proceedings of RushMore, these notes would be considered as assigned to SBA. Taxpayer also agreed that the terms and conditions contained in the standby agreement would apply to all future loans made by taxpayer to RushMore.

9. Taxpayer sold, at his cost to RushMore, the two timber sales contracts in South Dakota.

10. Taxpayer, in his personal capacity, became a surety on a bond of $200,000 to insure payment of all merchandise liens in connection with the construction of RushMore's facilities.

11. Taxpayer, as president of RushMore, agreed that no compensation was to be paid to the officers of RushMore without written approval of SBA.

12. Taxpayer, in his personal capacity, became surety on the performance bonds of timber purchased in the South Dakota area.

The conditions of the loan were met and RushMore received the $250,000 loan proceeds in installments, the first in October of 1956, and the last in March of 1958. (I-R. 44.)

Sometime in early 1958, RushMore applied to SBA for a deferment of payment of the principal falling due from September 21, 1957, through July 21, 1958. As a condition to such deferment, SBA required taxpayer to execute an agreement dated February 14, 1958, under which he agreed to advance, or cause to be advanced, certain sums to RushMore covered by standby agreements. In compliance with the agreement, Lelco advanced

$23,548.15 and Sales advanced $23,705 covered by the standby agreement dated February 14, 1958. The board of directors of RushMore, on January 8, 1958, authorized RushMore to borrow from the United States National Bank of Portland, Oregon, a sum not to exceed $25,000. (I-R. 44.)

During the operation of RushMore's mill, Sales sold lumber produced by RushMore. Sales also sold lumber produced by Lelco after its inception. Sisters sawed logs for Lelco also after its formation. (I-R. 46-47.)

On June 28, 1960, a fire at RushMore destroyed the sawmill and other related facilities but did not destroy the dry kilns and planing mill and certain other facilities. The book values of the destroyed assets at the time of the fire were as follows (I-R. 44-45):

Portable sawmill and related facilities transferred to RushMore by the partnership	$86,900.00 5/	
Equipment installed by RushMore	80,550.48	
Building constructed by RushMore	9,540.69	$176,991.17
Less reserve for depreciation		52,073.95 6/
		$124,917.22

RushMore received insurance proceeds of $124,307.24 for these destroyed assets. It was determined that the fire loss was $147,529.04. Because RushMore's facilities were under insured, it received only the $124,307.24 ($125,000 less $692.76 of scrap retained by it in lieu of cash). (I-R. 45.)

5/ Amount assigned as actual value at time of transfer to RushMore, not book value of transferor partnership. (I-R. 45.)

6/ Includes depreciation of the $86,900 on 10-year straight-line basis, not depreciation of the transferor's lower basis which RushMore was required to use for income tax purposes. (I-R. 45.)

SBA required that the insurance proceeds of $124,307.24 be applied to reduce the indebtedness and, accordingly, this was done. (I-R. 45.)

On October 11, 1962, the $250,000 note evidencing the loan was marked "paid" after certain other facilities of RushMore were sold to satisfy part of the loan to SBA. (I-R. 45.) Attempts were made to sell its remaining facilities as a unit, but were unsuccessful. (I-R. 45-46.)

Taxpayer performed services for various of his corporations. He received salaries from Sales and Lelco but he never received any salary from RushMore. Payment of this was prohibited by the SBA loan agreement. (I-R. 47.)

Taxpayer sold to the partnership, over a period of years, large quantities of timber. After the formation of Lelco, taxpayer continued to sell timber to the corporate successor of the partnership. (I-R. 47.) In selling timber, taxpayer did not advertise nor engage salesmen or realtors but merely supplied his operations with needed timber. (II-R. 96-97.) Taxpayer claimed capital gain treatment on such sales on the basis that timber and rights therein which he owned were capital assets. (I-R. 47.) 7/

Taxpayer did not sell any timber to RushMore at a profit. A condition in the loan authorization required that he sell to RushMore at his cost the timber covered by U.S.F.S. Contracts Nos. 12-11-002-11942, and 12-11-002-11943, respectively executed on March 7th and 8th of 1956. These were the only two sales of timber property by taxpayer to RushMore. With

7/ For the tax years 1955 and 1956, in a protest to the District Director and in a petition to the Tax Court of the United States (Docket No. 78340), taxpayer claimed that timber and timber cutting contracts sold by him were capital assets. (Ex. 34-AH, Ex. 36-AJ pp. 3, 4.)

the exception of these Forest Service contracts, taxpayer did not own any timber or timber cutting rights in the South Dakota area. (I-R. 47-48.)

Taxpayer never sold stock in a corporation which he formed or caused to be formed or in a corporation controlled by him. He never received a dividend from any of his corporations. Taxpayer did not form RushMore as a promoter with the intention of selling the stock at a profit, collecting a promoter's fee or commission, or receiving any dividends. (I-R. 48.)

In his 1961 joint income tax return, taxpayer charged off as worthless, and took as a business bad debt deduction $129,000 of the $144,968.55 he advanced to RushMore. (I-R. 18, 48.) The Commissioner, in his statutory notice of deficiency (I-R. 7-10) disallowed the deduction in its entirety. The taxpayer filed a petition with the Tax Court for a redetermination of his deficiency. (I-R. 1-5.) The Tax Court, upon the record evidence, sustained the determination of the Commissioner. (R. 54.) Thereafter, taxpayer filed a petition for review to this Court. (I-R. 56.)

SUMMARY OF ARGUMENT

The Tax Court correctly determined that the amount of $129,000, advanced by the taxpayer to his closely held corporation did not qualify for the bad debt deduction under Section 166(a) of the Code because the advances was not created in connection with any trade or business in which the taxpayer was engaged, and was only partially worthless during the taxable year in issue. Section 166(a) and (d) authorizes an ordinary loss deduction for business bad debts, and only a capital loss deduction for non-business bad debts.

A business bad debt may be deducted in whole or in part, depending upon the degree of its worthlessness, whereas a non-business bad debt can only be deducted in the year it becomes wholly worthless. A taxpayer qualifies for a business bad debt deduction only if he establishes that he was in a trade or business, and the debt bore a proximate relation to that trade or business of the taxpayer. A taxpayer is considered to be carrying on a trade or business only when the dominant intent behind his activity is to make a profit from the very activity. Moreover, that debt must bear a sufficiently direct relationship to the taxpayer's business to entitle him to a business bad debt deduction.

The Tax Court's decision that taxpayer had failed to establish that his advances were incurred in connection with a trade or business, not being clearly erroneous, is entitled to affirmance. The taxpayer failed to establish that he was in the business of being an employee of RushMore. Further, while the Tax Court found that taxpayer was in a trade or business with regard to his other enterprises, taxpayer failed to establish that any of his advances to RushMore bore a sufficiently direct relationship to these businesses to qualify the worthlessness therefrom as business bad debts.

ARGUMENT

THE TAX COURT CORRECTLY DETERMINED THAT THE AMOUNT OF $129,000, ADVANCED BY THE TAXPAYER TO HIS CLOSELY HELD CORPORATION (RUSHMORE) DID NOT QUALIFY FOR THE BAD DEBT DEDUCTION UNDER SECTION 166(a) OF THE INTERNAL REVENUE CODE OF 1954 BECAUSE THE ADVANCES WERE NOT CREATED IN CONNECTION WITH ANY TRADE OR BUSINESS THE TAXPAYER WAS IN, AND WERE ONLY PARTIALLY WORTHLESS DURING THE TAXABLE YEAR IN ISSUE

A. Introduction

Section 166 of the Internal Revenue Code of 1954, supra, is the statutory authorization for the deduction of losses suffered by taxpayers as a result of bad or worthless debts. This section is exclusive and controlling here. Putnam v. Commissioner, 352 U.S. 82. Section 166 distinguishes between individuals and corporations. The latter may deduct from income all debts whether partially or wholly worthless. In the case of an individual, a distinction is made between non-business and business bad debts. A non-business debt is deductible only if it becomes entirely worthless in the taxable year, and the resulting loss is to be treated as a short term capital loss. A bad debt is a business bad debt and is deductible in whole or in part, to the extent of proven worthlessness if the debt is created or acquired in connection with, or incurred in the taxpayer's trade or business. Treasury Regulations on Income Tax (1954 Code), Section 1.166-5(b), provides:

Sec. 1.166-5 Nonbusiness debts.

*   *   *

(b) Nonbusiness debt defined. For purposes of Section 166 and this section, a nonbusiness debt is any debt other than--

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a non-business debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worhtless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See Sec. 1.165-5, relating to losses on worthless securities.

* * *

(26 C.F.R., Sec. 1.166-5.)

Thus, for taxpayer to avail himself of the business bad debt provision of Section 166(a)(2), he must show that the loss suffered from the advances becoming worthless was proximately related to the conduct of a trade or business in which he was engaged at the time the

debt became worthless. 8/ Whipple v. Commissioner, 373 U.S. 193; United States v. Keeler, 308 F. 2d 424 (C.A. 9th); Weddle v. Commissioner, 325 F. 2d 849 (C.A. 2d).

Because the business of a corporation is distinct from that of its shareholders (Deputy v. duPont, 308 U.S. 489; Burnet v. Clark, 287 U.S. 410; Dalton v. Bowers, 287 U.S. 404), the individual shareholder who owns a group of corporate enterprises and manages his investments therein which may include occasional advances of money to them is not conducting a trade or business. His return is that of an investor's return and his bad debts are non-business even though the corporation is involved in a trade or business. Whipple v. Commissioner, supra; Higgins v. Commissioner, 312 U.S. 212; Kelly v. Patterson; 331 F. 2d 753 (C.A. 5th).

In Higgins the taxpayer had extensive investments in bonds and stocks as well as in real estate. He devoted a considerable portion of his time to the management of his investments and also maintained two offices where a total of five persons were employed for this purpose. Approximately one-third of this time and effort was devoted to the management of the investment in stocks and bonds. The Supreme Court, affirming the Board of Tax Appeals and the Court of Appeals, held that the management of the securities did not constitute a business of the taxpayer, so that the taxpayer could not deduct expenses incurred in connection with the management of the bonds and stocks.

8/ Section 166 of the 1954 Code reenacted Section 23(k) of the 1939 Code with only one substantive change not relevant here. S. Rep. No. 1622, 83d Cong. 2d Sess., p. 124 (3U.S.C. Cong. & Adm. News (1954) 4621, 4654).

In Whipple the taxpayer had organized a number of corporations, contributing to each his own initiative and energy and such financial backing as it required. The Supreme Court, sustaining the Court of Appeals for the Fifth Circuit, held that the taxpayer's activities with regard to these corporations did not constitute a separate business, so that a bad debt resulting from a loan to one of these corporations did not constitute a business bad debt. It did not matter how many corporations were involved or how extensive taxpayer's activities had been, for the only return taxpayer could have derived from these activities was that of an investor. The Court stated (p. 202):

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the persons so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.

Even when a taxpayer establishes that he is in a trade or business, he must further establish that the advances were proximately related to that business. Whipple v. Commissioner, supra; Weddle v. Commissioner, supra. In Whipple v. Commissioner, supra, the Supreme Court stated (p. 202):

> Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those

> actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Further, the Court, in Whipple, supra, at p. 202, cautioned that the "non-business" bad debt provision--

> was intended to accomplish far more than to deny full deductibility to the worthless debts of the family and friends. It was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls far short of reaching every income or profit making activity.

In the instant case, taxpayer had been engaged in the timber and lumber manufacturing businesses in Oregon. He had devoted a good deal of capital and time to these ventures. (I-R. 38.) Prior to 1951, he conducted this business as a sole proprietor at Bend, Oregon. After 1951, this business was reorganized into a partnership in which taxpayer had a seventy percent interest. The principal asset of this enterprise was a saw mill. (I-R. 46.)

During 1952, taxpayer organized and incorporated Sales for the purpose of acting as a sales agent for his lumber manufacturing businesses. All of the stock of Sales was owned by taxpayer and his wife. (I-R. 46.) At about this time taxpayer organized, as a sole proprietorship, the Sisters sawmill. (I-R. 46-47.)

During the operation of these businesses taxpayer bought and sold timber and timber cutting contracts to his enterprises. He generally claimed capital gain treatment for these sales on the basis that these assets were capital assets. (I-R. 47.)

The partnership was reorganized into two distinct corporations, Lelco and RushMore. The majority of the assets were transferred to Lelco which took over the Oregon operations. The balance of the assets

including a portable sawmill were transferred to RushMore. (I-R.39.) Taxpayer owned 59.6 percent of RushMore's stock after its incorporation and transfer of the partnership assets. (I-R. 41.)

Due to the fact that RushMore was unable to borrow money through banks, it had to seek assistance from SBA. (I-R. 41, 42.) As part of the conditions of such loan, taxpayer had to act as a guarantor, had to mortgage Sister's assets as collateral, and had to agree to forego collection of such advances under certain conditions. (I-R. 42-43.) In addition, taxpayer agreed to sell his timber interests in South Dakota to RushMore at cost. Further, taxpayer agreed that no salary would be paid to any officer of RushMore without SBA's approval. (I-R. 43.)

Thereafter, RushMore ran into financial difficulties and was unable to meet the SBA loan installments as they came due. Consequently, the taxpayer assumed certain appointed responsibilities under the standby agreements. Subsequently, a fire at RushMore destroyed the sawmill and related facilities. (I-R. 44.) RushMore received $124,307.24 of insurance proceeds although the fire loss was about $147,000. The insurance proceeds were required to be applied against the SBA loan. Thereafter, the note evidencing this loan was marked paid. (I-R. 45.)

Taxpayer's only timber interests in South Dakota were the two sales contracts he sold to RushMore at his cost. (I-R. 47-48.) Taxpayer did not own any timber or timber cutting rights in that area and he did not sell any other timber to RushMore. (I-R. 48.)

Upon consideration of the record evidence, the Tax Court sustained the determination of the Commissioner that the advances were only non-business bad debts and not deductible in the year claimed. The

Tax Court concluded that taxpayer was engaged in a trade or business of (1) rendering services to corporations as an officer and employee thereof, (2) of selling timber to various entities for profit, and (3) of operating a sawmill and manufacturing lumber at his plant in Sisters, Oregon. The Tax Court held that while taxpayer could be considered to be in the trade or business of being an employee in connection with services rendered to his various enterprises, he was not so engaged as far as his connection with RushMore was concerned. Further, it concluded that there was no proximate relation between his trade or business of being an employee of Lelco and Sales and his advances to RushMore. Additionally, the Tax Court concluded that there was no proximate relationship between his business of selling timber and his loans to RushMore. Finally, the lower court found that the record was devoid any evidence showing that his advances to RushMore bore a proximate relation to the operation in Sisters. (I-R. 48-54.) The conclusions of the Tax Court, being supported by the record evidence, are correct and should be affirmed on appeal.

The issues before the Court are basically factual and the Tax Court's holdings should not be overturned unless clearly erroneous. Higgins v. Commissioner, supra; Whipple v. Commissioner, supra; Hirsch v. Commissioner, 315 F. 2d 731 (C.A. 9th); United States v. Keeler, supra; Lamont v. Commissioner, 339 F. 2d 377 (C.A. 2d); Commissioner v. Duberstein, 363 U.S. 278. The taxpayer has the burden of proving that the facts bring his case within the elements necessary to entitle him to the deduction. Whipple v. Commissioner, supra; Hirsch v. Commissioner, supra; Lamont v. Commissioner, supra, p. 380 (C.A. 2d); United States v. Byck, 325 F. 2d 551 (C.A. 5th).

Taxpayer did not contend before the Tax Court and does not contend before this Court that he was in the business of either promoting corporations or loaning money and it is clear from the record evidence that he was not. (I-R. 35-36, 48.) See United States v. Byck, supra; Bodzy v. Commissioner, 321 F. 2d 331 (C.A. 5th.): United States v. Clark, 358 F. 2d 892 (C.A. 1st), rehearing denied 358 F. 2d 896, certiorari denied, October 10, 1966 (35 U.S. Law Week 3125). Taxpayer's contentions are (1) that he was in the business of being an employee of RushMore (2) that the loans bore a proximate relation to such employment, and (3) that in any event, the advances bore a proximate relation to the businesses which the Tax Court held he was in.

B. The Tax Court correctly found that taxpayer was not in the business of being an employee of RushMore, and therefore it correctly concluded that the advances were not incurred in connection with any business of rendering services to RushMore

The spending of money, time and effort as a corporate executive or in any activity or venture in the general realm of business does not per se put taxpayer in the business of being an employee within the meaning of the statute. Hirsch v. Commissioner, supra, p. 36. This Court has clearly stated that the fundamental test in determining whether taxpayer is in a trade or business is whether the activities were engendered by a dominant income or profit motive. This Court stated with respect to this as follows (p. 736):

> * * * Congress intended that the profit or income motive must first be present in and dominate any taxpayer's "trade or business" before deductions may be taken. * * * the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be ultimately to make a profit from those very same activities. * * * Absent that basic and dominant motive, the taxpayer's activities, no matter how intensive, extensive, or expensive, have not been construed by the Courts as carrying on a trade or business * * *. (Emphasis supplied.)

Taxpayer cannot be contending that he is in the business in which RushMore was engaged since it is clear that the corporation and its stockholders and employees are to be treated separately and the business of the corporation is not the business of the employee. Whipple v. Commissioner, supra. Therefore, taxpayer's contention, although not clearly spelled out, is that his trade or business in relation to RushMore was that of an employee therein.

The evidence certainly does not establish that taxpayer's dominant purpose was that of making a profit as an employee of RushMore. Rather, it is clear that the services he performed for it were related to a dominant purpose of producing and insuring a return on his investment.

Preliminarily, taxpayer's extreme reliance (Br. 25) on the stipulation of fact (I-R. 35-36, 48) and findings of the Tax Court incorporating that stipulation (I-R. 38) to the effect that taxpayer did not form RushMore with the intention of selling the stock at a profit or receiving a dividend is not at all probative of the fact that he was in the business of being an employee of RushMore. One need not dig very deeply to discover ways to disguise a return on capital to an officer-shareholder as through the guise of a salary to that officer. See Botany Mills v. United States, 278 U.S. 282. Certainly one who has invested as much capital in RushMore as taxpayer has is going to seek a return on such capital aside from any normal remuneration for services rendered. Further, we are puzzled as to why taxpayer believes (Br. 19) the Tax Court's finding that taxpayer performed services for RushMore aids him in the least. Certainly, a majority shareholder in a closely held corporation will usually perform services for the corporation which only enhance or at least insure the value of his investment. What more productive activity can a prudent investor engage in than actively running the operation of the business he has invested in?

Taxpayer's activities with relation to RushMore were no more than that of an investor seeking a return on his investment. The Tax Court found (I-R. 42) that there were no present plans for compensation of the

officers or directors of RushMore and none were contemplated.

Contrary to what taxpayer states (Br. 19), the Tax Court did not find that taxpayer would have received a salary but for the SBA restrictions. The Tax Court more accurately found, in line with the stipulation of facts (I-R. 34), as follows (I-R. 47):

> Petitioner never received a salary from RushMore, payment of any salary to him being prohibited by the S.B.A. loan agreement.

Perhaps taxpayer would have been compensated sometime in the future for his services by payment of a salary. However, taxpayer has not established when he would have been paid, how much, or how regular it was to be. Under these circumstances, his so-called salary is at the risk of the successful operation of the business which puts him in no better position than an investor waiting for a return on his capital. Taxpayer by his own testimony admits (II-R. 23) that it was his plan to start RushMore with as little capital as possible, do it on credit, skin by, and wait for the profit to come. Further, taxpayer stated (II-R. 34) that after SBA's restrictions were removed he hoped he could take a salary. This establishes that there was no definite expectation of salary at any time, but anticipation of some future profit on a capital investment. A salary is a regular and fixed compensation for continual services; taxpayer's remuneration was speculative and indefinite.

Taxpayer's whole argument on this point is that if there is some hope or expectation of taxpayer's being paid a salary in the future, then his undertaking suddenly becomes a trade or business of an employee.

Taxpayer relies (Br. 20) upon the statement from this Court's opinion in Hirsch (p. 736):

> While the expectation of the taxpayer need not be reasonable, and immediate profit from the business is not necessary, nevertheless, the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be ultimately to make a profit or income from those very same activities.

Certainly this passage only emphasizes the burden on a taxpayer not merely to show some expectation of future profit but to show that the dominant intent is ultimately to make a profit on the activity of being an employee as opposed to that related to investment. This, the taxpayer has failed to do. 9/

Trent v. Commissioner, 291 F. 2d 669 (C.A. 2d), relied by taxpayer (Br. 18), is basically distinguishable. While the court held, in that case, that a shareholder of a corporation can be in a trade or business of being an employee in that corporation, it did so on the basis of a factual situation far removed from that present in this case. In that case, taxpayer had been an employee of American Express Company for 16 years prior to accepting employment with Caldwell Inc. at a salary of $150 a week. He also was to serve as vice-president and business manager of Plastic, Inc., of which Mr. Caldwell was half owner and

9/ See United States v. Clark, supra, p. 896 wherein the Court of Appeals, on petition for rehearing, stated (p. 896):

> We thought Whipple to be controlling because of its clear implication that when a taxpayer's loss producing activities are at least equally consistent with his being an investor as with his being in the business of promoting, financing or managing the enterprises in question, he has not met his burden. (Emphasis supplied.)

president. Taxpayer was required to pay $5,000 for one third of the stock of Plastic. In addition Caldwell advised taxpayer he could be expected to make loans to Plastic & Caldwell, Inc., until their cash condition improved. In the instant case taxpayer owned seventy percent of RushMore, has continually been an entrepreneur in relation to all his business undertakings, and he was the moving force behind their successful operation. He was neither paid a salary nor were there any definite plans to pay him one in the future.

In relation to his services performed for RushMore, the taxpayer is in no different position than that of an investor. The Supreme Court's statements in Whipple, supra, clearly confirm this as follows (p. 197):

> * * * the case before us inexorably rests upon the claim that one who actively engages in serving his own corporations for the purposes of creating future income through those enterprises is in a trade or business. That argument is untenable in light of Burnet, Dalton, DuPont and Higgins, and we reject it. Absent substantial additional evidence, furnishing management and other services to corporations for a reward no different than that flowing to an investor in those corporations is not a trade or business under Sec. 23(k)(4).

C. The Tax Court correctly found that the taxpayer's advances were not proximately related to any of the business which the Tax Court found taxpayer to be engaged in

The Tax Court found that taxpayer was in the business of being an employee in connection with services rendered to Lelco and Sales, that he was in the business of operating a sawmill and manufacturing lumber at the Sisters plant, and that he was in the business of selling timber and timber rights. (R. 50, 52.) The Tax Court ultimately found that

that the taxpayer's advances bore no proximate relationship to these businesses sufficient to make the advances deductible as a business bad debts. (R. 51.) These findings of the Tax Court, not being clearly erroneous, are entitled to affirmance.

This Court in O'Neill v. Commissioner, 271 F. 2d 44, 48 (C.A. 9th), espoused a rule pertinent to the determination of whether a debt is incurred in a taxpayer's trade or business in the following (p. 48):

> It is well settled that the only instances in which the taxpayer who owns a corporation, recognized as a tax entity, can take a business loss deduction for his financing of the corporation, either by way of loans or contributions to capital, are (1) where he is in the business of loaning money, or (2) he is in the business of promoting, financing, and managing business enterprise. Holtz v. Commissioner, 9 Cir., 1958, 256 F. 2d 865, 870; * * *.

However, in United States v. Keeler, supra, this Court recognized additional factors which are pertinent to the determination, in the following (p. 429):

> The government concedes that the O'Neill rule, while determinative in the circumstances presented in that case, is not the sole criterion, and that if the loans bear a sufficiently direct relationship to taxpayer's business, they may qualify as business debts, even though the taxpayer's business is not that of loaning money or promoting business enterprises. (Emphasis supplied.)

The Supreme Court's decision in Whipple, supra, which was rendered after this Court's decision in Keeler, did not, in any respect, modify the criteria espoused in Keeler, supra, since that Court reached no decision with respect to the issue of proximate relationship.10/ The Supreme

10/ While this Court has taken full cognizance of the Whipple decision in United States v. Drown, 328 F. 2d 314 (C.A. 9th), wherein it remanded a determination by the District Court that a taxpayer's activity in dealing in enterprises was a separate and distinct business in light of the Supreme Court's decision in Whipple, supra, it does not appear to have modified the rule espoused in Keeler, supra, p. 426.

Court specifically remanded the case for a further determination by the lower courts and stated that it took no position with regard to this issue. However, there is some general language in the Supreme Court's opinion pertaining to this issue. The Court stated as follows (pp. 201, 204):

> [The 1942 amendment to Section 23(k) of the 1939 Code] * * * was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a <u>concept which falls far short of reaching every income or profit making activity</u>.
>
> *   *   *
>
> Moreover, there is no proof (which might be difficult to furnish where the taxpayer is the sole or dominant stockholder) <u>that the loan was necessary to keep his job</u> or was otherwise proximately related to maintaining his trade or business as an employee. (Emphasis supplied.)

While the Second Circuit in <u>Trent</u> v. <u>Commissioner</u>, <u>supra</u>, seems to have rejected the approach taken by this Court in <u>O'Neill</u>, <u>supra</u>, nevertheless that Circuit in <u>Weddle</u> v. <u>Commissioner</u>, <u>supra</u>, formulated a test which parallels this Court's test in <u>Keeler</u>, <u>supra</u>. The court in <u>Weddle</u>, <u>supra</u>, p. 851, stated that a bad debt which bears a proximate relation to a trade or business of a taxpayer is one in which the creation of that debt was <u>significantly motivated</u> by the taxpayer's trade or business. It seems significant to point out that Chief Judge Lumbard's concurring opinion in <u>Weddle</u>, <u>supra</u>, criticized the majority opinion and set out an even more restrictive test for measuring the proximate relationship of a debt to a trade or business. The Chief Judge stated (p. 852):

> In attempting to draw this distinction, as the Tax Court wisely noted in considering Mrs. Weddle's claim, we have no "scales sufficiently sensitive to be able to ascertain the exact percentage of motivations which impelled [her actions]", and therefore "we look to the main and dominant reasons for [her actions]". (Emphasis supplied.)

Measured by the standard set down by this Court in Keeler, supra, or even by the Second Circuit in Weddle, supra, it is abundantly clear that taxpayer has failed to establish that his advances bore a proximate relationship to any trade or business he was adjudged to be engaged in. Viewing taxpayer's business of being an employee of Lelco and Sales, there is virtually little or no evidence which establishes that the advances were necessary for taxpayer to retain his employment in these corporations. Both Lelco and Sales maintained their independent economic existence aside from any business they received from RushMore and there was no showing that these entities were dependent upon RushMore's business or could not find sources elsewhere upon the demise of RushMore. With regard to taxpayer's business of buying and selling timber, the record demonstrates that while taxpayer owned and sold timber and timber cutting rights to his other businesses, he owned no timber or timber cutting rights in South Dakota. (R. 48.) Since he was required to sell his timber sales contracts at cost to RushMore, there was no apparent attempt to make a profit on any such sales. Therefore, the advances could not be deemed to have been made pursuant to any profit making activity or for the purpose of protecting any profit making activity. In any event, taxpayer has failed to establish that he could not have sold the timber sales contracts in South Dakota to buyers other than RushMore. Finally, the operation at Sisters, which sawed logs for Lelco, was totally

independent from RushMore and was not proven to have had any connection with RushMore, aside from common ownership and management.

Certainly the facts present in the instant case fall short of bringing it within the Trent doctrine or even the caveat in the Weddle case, supra, p. 851, quoted by taxpayer. (Br. 32.) In essence, taxpayer has failed to prove that the advances were necessary for him to maintain the trades or business he was in.11/

The facts present in Trent, supra, provide a significant contrast to those present in the instant case. The taxpayer in that case was only a minority shareholder and was required as a condition of his employment to make advances to the companies there involved. In the instant case, taxpayer was the dominant shareholder or owner in all his trades and businesses and the advances involved have not been shown to have been a necessary condition for the continuance of his businesses. Where the taxpayer is the dominant or sole shareholder in his trade or business, the burden of proving that the loan was necessary to preserve that trade or business is a difficult one, if not impossible. Whipple v. Commissioner, supra, p. 204. It is this burden which the taxpayer has fallen far short of satisfying.12/

11/ In view of the fact that the Tax Court found that taxpayer was not in a trade or business with respect to his position of an officer in RushMore, the Tax Court made no findings with respect to the issue of whether his advances were proximately related to a non-existent business. However, if this Court should reverse the Tax Court's factual conclusion and hold that the taxpayer was in a trade or business of rendering services to RushMore, the Commissioner argues that it will be necessary to remand the cause back to the lower court for further findings on the issue of whether the advances were proximately related to this business.

12/ In the lower court, the Commissioner contended that the taxpayer's advances to RushMore, as are here in issue, constituted equity capital rather than debt. The Tax Court reached no conclusion with respect to this issue but did express "doubts" as to whether the advances created genuine indebtedness. (R. 49.) It stated (I-R. 49-50):

(contd on next page)

Because the advances were not created in connection with any trade or business that the taxpayer was in, and they were only partially worthless during 1961, the Tax Court correctly concluded that the amount of $129,000 was not deductible at all.

CONCLUSION

For the reasons above, the decision of the Tax Court is correct and should be affirmed on appeal.

Respectfully submitted,

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NOVEMBER, 1966.

12/ (contd from previous page)

The fact that no outside source would make the advances, the fact that the advances were subordinate to the S.B.A. loan, the fact that the advances had to be made before the S.B.A. would grant its loan, the fact that the interest rate was 4 percent while the S.B.A. interest rate was 6 percent, and the fact that the advances were all uninsured while the S.B.A. loan was fully guaranteed and covered by mortgages all seem to indicate that the advances were in reality contributions to the capital of RushMore.

The Commissioner contends that if this Court should reverse the Tax Court's decision, it should remand the cause to the Tax Court for further findings and conclusions on the issue of whether the advances were genuine indebtedness. Since this Court has held that the issue of whether advances by an individual to a corporation are debt or equity is basically one of fact (Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F. 2d 222 (C.A. 9th)), further findings are necessary.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:____________________day of________________, 1966.

____
Attorney

No. 20897

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

LEONARD LUNDGREN and EVELYN R. LUNDGREN,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

APPELLANTS' REPLY BRIEF

Appeal from the Tax Court of the United States

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APPELLANTS' REPLY BRIEF

Appeal from the Tax Court of the United States

Respondent Fails to Recognize that Loans Incident to the Expansion of Existing Trades or Businesses into a New Geographic Area are Created "In Connection With" Such Trades or Businesses.

Respondent accepts verbatim the Tax Court's key conclusion that Petitioner, Leonard Lundgren, was engaged in the trades or businesses of:

(i) Rendering services to corporations as an officer and employee thereof, and

(ii) Selling timber to various entities for profit. (Br. 20).

In addition, Respondent acknowledges that Petitioner was the moving force behind the operation of all his business undertakings.

An individual engaged in the trade or business of rendering services to corporations necessarily expands such trade or business when he forms a new corporate employer expected to generate additional compensation for services rendered. Likewise, an individual engaged in the trade or business of selling timber to entities at a profit necessarily expands such trade or business when he forms a new corporation in a new geographic area where timber is available and the new corporation is expected to purchase timber from the individual at a profit.

To escape the nonbusiness debt classification, loans only need be created "in connection with" a trade or business of the taxpayer. Loans essential to the creation of a new corporation which will expand existing trades or businesses certainly are created "in connection with" the existing trades or businesses. Nothing in Section 166(d)(2) requires that Petitioner's activities be fragmentized per corporate entity and per geographical area as done by the Tax Court and Respondent in order to avoid ascertaining a "connection" between:

> (i) Petitioner's recognized trade or business of rendering service to Lelco, Inc. and Lundgren Sales Corporation, and Petitioner's recognized trade or business of selling timber to Lelco, Inc; and
>
> (ii) The expansion of the before-mentioned trades or businesses into South Dakota through the formation of RushMore and the loans incident thereto.

There was nothing fanciful or illusionary about Petitioner's expectations of deriving economic benefits from the expansion of his individual trades or businesses into South Dakota through creation of a new corporate employer and a new purchaser of timber. Absent in the instant case is any competing motivation attributable to Petitioner's stock ownership in RushMore. As stipulated by the parties and found by the Tax Court, Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. This stipulation and finding confirms Petitioner's corroborated testimony that his formation of RushMore was motivated by the expectation of ultimately receiving (when permitted by elimination of the SBA loan restrictions) salary for services rendered to RushMore, and profit from the sale of timber to RushMore.

Although Respondent recognizes that Petitioner was engaged in the trade or business of rendering services to corporations because of his employment by Lelco, Inc. and Lundgren Sales Corporation, and in the trade or business of selling timber to the various entities because of Petitioner's timber sales to Lelco, Inc. and the predecessor partnership, Respondent denies that the advances were created in connection with such trades or businesses because:

> "...In essence, taxpayer has failed to prove that the advances were necessary for him to maintain the trades or business he was in." (Br. 30)

Similarly, in the paragraph after the above quotation, Respondent expresses Petitioner's burden of proof as requiring a showing that the loan was necessary to *preserve* the trade or business.

On the preceding page, Respondent emphasizes the lack of evidence establishing that the advances were necessary for Petitioner to *retain* his employment with Lelco, Inc. or Lundgren Sales Corporation (Br. 29). It is perfectly true, as Respondent claims, that Petitioner could have continued his corporate employment business with Lelco, Inc. and Lundgren Sales Corporation, and his timber sales business with Lelco, Inc. in the absence of loans to Rush-More. Venturing into South Dakota was not required for continuation of Petitioner's individual trades or businesses in Oregon. While loans necessary to maintain an existing trade or business in its present form at the same location serving the same customers are certainly created "in connection with" such trade or business of the taxpayer, maintaining the status quo is not the *exclusive* manner in which a loan may be created "in connection with" a trade or business. The term "in connection with" is broad in scope. Loans incident to the expansion of an existing trade or business into a new geographic area have as direct a connection with the trade or business sought to be expanded as loans required for the survival or continuation of the trade or business.[1]

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[1] Contrary to the assertions made by Respondent (Br. 25), Petitioner does not rely upon Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir. 1961) for purposes of sustaining the proximate relationship. Petitioner cited Trent v. Commissioner only in footnote 2 on page 18 of the opening brief for the general proposition that the performance of services as an employee constitutes the conduct of a trade or business. The difference in the fact situation between Trent and the instant case is recognized. The loans were made by the taxpayer in Trent to preserve his job while the loans were made by the Petitioner to RushMore for the purpose of expanding his trade or business of performing services for corporations through the creation of a new employer.

Respondent's restricted interpretation of the term "in connection with" may stem from his reliance on the statement of this Court in United States v. Keeler, 308 F.2d 424 (9th Cir. 1962) that loans must "bear a sufficiently direct relationship to taxpayer's business" before they qualify as business debts (Br. 27). As reviewed under the next heading, when United States v. Keeler is analyzed, it supports Petitioner, not Respondent.

Respondent Misinterprets the Import of This Court's Opinion in United States v. Keeler

United States v. Keeler involved a taxpayer who conducted an industrial laundry business through a partnership owned and controlled 82.5% by him. Joining with two other individuals likewise engaged in the industrial laundry business, the taxpayer formed a Canadian corporation to conduct the same type of industrial laundry business in Toronto, Ontario. Financial adversity beset the Canadian corporation, and the taxpayer claimed a business bad debt deduction for $88,588.90 in unpaid advances made by him to the corporation.

The industrial laundry business in Seattle was the only trade or business cited by the taxpayer in Keeler for purposes of satisfying the "in connection with" requirement of the non-business debt exclusion. Conduct of the industrial laundry business in Toronto by the Canadian corporation could not be considered an expansion of the taxpayer's Seattle laundry business because the business of a corporation is separate and distinct from that of a stockholder. In an effort to establish

a proximate relationship between the Seattle laundry business and the laundry business conducted by the Canadian corporation in Toronto, the taxpayer cited a number of indirect ways whereby the Toronto operation was expected to benefit the Seattle laundry business. After observing that these anticipated indirect benefits to the Seattle business seemed more fanciful than real, this Court held they did not establish a sufficiently close relationship to warrant the deduction of the advances as a bad debt even if the claimed benefits were accepted at face value.

If, in the instant case, Petitioner pointed to the lumber manufacturing business in Oregon for purposes of satisfying the "in connection with" requirement of the nonbusiness debt exclusion, the lumber manufacturing business conducted by RushMore in South Dakota could not be considered as an expansion of Petitioner's individual business because the business of a corporation is separate and apart from that of the stockholder. However, Petitioner, unlike the taxpayer in Keeler, relies upon the business of rendering services to corporations and the business of selling timber to entities for purposes of establishing the requisite connection with RushMore's business. While the lumber manufacturing business of RushMore could not be considered as an expansion of Petitioner's individual lumber manufacturing activities in Oregon, the business of RushMore could expand the corporate employment business of Petitioner by furnishing another employer, and expand Petitioner's timber sales business by supplying a new purchaser in a new geographic area. In short, the fact situation faced by this Court in Keeler was much different from the situation here presented.

The complexion of United States v. Keeler is completely changed when the facts are reconstructed to parallel those here involved. Such reconstructed facts are:

(1) The Seattle industrial laundry business was conducted through a corporation, successor to a partnership.

(2) The taxpayer individually was engaged in the business of selling soap to the Seattle industrial laundry corporation, and the taxpayer had similarly been engaged in the business of selling soap to the predecessor partnership.

(3) Sales for the Seattle laundry were handled by a separate sales corporation.

(4) The taxpayer was president of, performed services for, and received compensation from the Seattle laundry corporation and the sales corporation.

(5) Respondent recognized: that the taxpayer was engaged in the trade or business of rendering services to corporations as an officer and employee; and Respondent recognized that the taxpayer was engaged in the trade or business of selling soap to various entities.

(6) Respondent had stipulated that the taxpayer did not participate in the formation of the Canadian corporation with the intention of selling the stock at a profit or receiving any dividends.

(7) The economic benefits which the taxpayer hoped to derive from the Canadian corporation were: compensation for services rendered as president, and profit from the sale of soap, such compensation for services and profit from soap sales to commence after elimination of first mortgage loan restrictions incurred in connection with plant financing.

Under such facts, as reconstructed, loans to the Canadian corporation would have been created in connection with the taxpayer's trade or business of rendering services to corporations, and in connection with the taxpayer's trade or business of selling soap to entities, because the sole purpose and motivation behind

the taxpayer's participation in the formation of the Canadian corporation (and the loans incident thereto) would have been the expansion of his trades or businesses. Under such a fact situation, it would make no difference that no actual soap sales had been made to the Canadian corporation at a profit at least where the taxpayer had sold two truckloads of soap to the corporation at cost as required by the first mortgage restrictions, and the taxpayer knew he could obtain a Canadian supply of soap for sale to the Canadian corporation by the time elimination of the first mortgage loan restrictions permitted realization of profit from such sales.

In Keeler, the indirect benefits which the taxpayer's Seattle laundry business hoped to derive from the Canadian operation were admittedly anticipated future benefits, none of which actually materialized, and most of which required the establishment of a chain of industrial laundries in Canada, not merely successful operation of the Toronto laundry. If failure of a taxpayer to actually realize the motivating economic benefits precludes the relationship from being sufficiently direct to satisfy the "in connection with" requirement of the nonbusiness debt exclusion, this Court would have so stated in an abbreviated opinion. Instead, Keeler treats reasonably anticipated future benefits (as contrasted with fanciful benefits) in the same category as benefits actually received. If the benefits which Petitioner expected to receive from RushMore (compensation for services rendered and profit from the sale of timber) are considered as actually realized,

all grounds for the Tax Court's and Respondent's denial of the bad debt deduction are eliminated since their denial is founded upon the fact that Petitioner never received any compensation from RushMore, and never sold any timber to RushMore at a profit.

A pertinent question to be answered in all business vs. nonbusiness bad debt cases is: what really motivated the taxpayer to make the loans? This key question was answered as follows in United States v. Keeler, supra at 430:

> "The taxpayer here testified that in addition to the alleged benefits to his Seattle plant, he expected to realize profits from the Toronto plant and the other contemplated Canadian laundries."

The profits referred to in the above quotation were profits attributable to the taxpayer's stock ownership in the Canadian corporation. What if this Court had been convinced that Petitioner was really motivated by the alleged benefits to his Seattle plant, rather than by anticipated profits attributable to his stock ownership? In such event, this Court might well have found the requisite relationship despite the indirect nature of the alleged benefits. In the instant case, it is stipulated that Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends, thereby eliminating profit attributable to stock ownership as a motivating factor. This substantiates Petitioner's testimony that he was really motivated by the expectation of receiving compensation from RushMore for services rendered, and profits from the sale of timber to RushMore. Such motivating benefits are direct benefits to be derived from his trade or business of

performing services for corporations and his trade or business of selling timber to entities, not indirect benefits such as those asserted by the taxpayer in Keeler.

Respondent further cites United States v. Keeler as authority for his assertion that the issues before the Court are basically factual and the Tax Court's holdings should not be overturned unless clearly erroneous. Keeler actually holds to the contrary. The District Court had allowed Keeler the bad debt deduction by finding that the taxpayer entered into the transactions with the Canadian corporation for the benefit of, and to aid and nurture and build up his going business in Seattle. This Court reversed without any "clearly erroneous" assertions, stating that the question for determination was whether the factual situation found by the trial court was covered by the statute, a matter which may be reviewed by the appellate court. Id. at 432. The identical situation is here presented. Petitioner does not contest any of the evidentiary facts found by the Tax Court. Rather, Petitioner claims the factual situation found by the Tax Court falls within the non-business bad debt exclusion under Section 166(d)(2)(A).

Qualification Under the Nonbusiness Debt Exclusion is Clinched by the Fact that Petitioner's Activities Connected with RushMore Constituted the Conduct of Trades or Businesses

All of the foregoing argument applies whether or not Petitioner's activities connected with RushMore in and of themselves constitute the conduct of trades or businesses apart from his services performed as officer of Lelco, Inc. and RushMore Sales Corporation and apart from his sales of timber to Lelco, Inc. If, however, Petitioner's activities connected with RushMore constitute the conduct of the trade or business of performing services for RushMore or the trade or business of selling timber to RushMore, there is an undeniable connection between Petitioner's loans vital to the formation of RushMore and the conduct of such trades or businesses. It is not then a matter of expanding existing trades or businesses as is the case when Petitioner's employment by Lelco, Inc. and Lundgren Sales Corporation and Petitioner's timber sales to Lelco, Inc. are cited as the trades or businesses in connection with which the loans were created.

Respondent and Petitioner not only agree that Whipple v. Commissioner, 373 US 193 (1963) is the leading case concerning the circumstances under which devotion of time and energies to the affairs of a corporation by a controlling stockholder may be considered the conduct of a trade or business, but Respondent and Petitioner agree upon the precise portion of the

Supreme Court's opinion which is most pertinent to the issue. The import of the Whipple doctrine is summarized as follows by Respondent (Br. 17):

> "...It did not matter how many corporations were involved or how extensive taxpayer's activities had been, for the only return taxpayer could have derived from these activities was that of an investor."

In the above quotation, Respondent recognizes that extensive activities by a controlling stockholder fail to constitute the conduct of a trade or business where an investor's return is the only economic benefit which the stockholder hopes to derive from the activities.

A completely different situation is presented when an investor's return is negated as the economic motivation and when the monetary benefits sought from the corporation by the active

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[2] This portion of the Supreme Court's opinion in Whipple is cited on page 17 of Respondent's brief, is likewise quoted in footnote 4 on page 22 of Petitioner's brief. For convenience of reference, the quotation is repeated below. (373 U.S. 193 at 202):

> "Devoting one's time and energies to the affairs of a corporation is not of itself, and *without more* a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. *When the only return is that of an investor*, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." (emphasis added)

controlling stockholder can only be obtained through the conduct of trades or businesses. The following quotations from Respondent's brief indicate his awareness of the necessity for establishing that an investor's return was the dominant motivation for Petitioner's activities connected with RushMore:

> "...Rather, it is clear that the services he performed for it [RushMore] were related to a dominant purpose of producing and insuring a return on his investment." (Br. 23)
>
> ....
>
> "Taxpayer's activities with relation to RushMore were no more than that of an investor seeking a return on his investment." (Br. 23)

These assertions conflict with the stipulation that Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. The portion of Whipple quoted in the footnote at the bottom of page 12 above defines what is meant by an investor's return. It is income, profit or gain in the form of dividends or enhancement in the value of an investment. Profit or gain from enhancement in the value of a corporate investment can only be realized through sale of the corporate stock for more than the cost thereof. Such expectation did not motivate Petitioner, because, as stipulated Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends.

In an effort to circumvent the stipulation, Respondent observes that a return on capital may be extracted from a corporation through the guise of a salary, and infers that this was Petitioner's intention because "...One who has invested as much capital in RushMore as taxpayer has is going to seek a return

on such capital aside from any normal remuneration for services rendered." (Br. 23). It may be true, as Respondent suggests, that one who has advanced as much as Petitioner advanced to RushMore will seek an economic benefit from the corporation over and above normal remuneration for services rendered. This does not, however, dictate the conclusion that the additional economic benefit must be the return of an investor, particularly when such a conclusion conflicts with the stipulation. Rather, the added economic motivation (over normal remuneration for services rendered) expected by Petitioner was gain from the sale of timber to be realized after elimination of the SBA loan restrictions. Nowhere does Respondent's brief discuss, or even mention, the economic motivation attributable to Petitioner's expectation of realizing gain from the sale of timber to RushMore.

Only one other assertion is made by Respondent in support of his contention that Petitioner's activities relating to RushMore were no more than those of an investor seeking a return on his investment. Respondent claims receipt of a salary from RushMore was at the risk of the successful operation of the business since no salary could be received until the SBA restrictions were eliminated. Therefore, according to Respondent, Petitioner is in no better position than an investor waiting for a return on his capital which is likewise at the risk of the successful operation of the business. Dependency of the ultimate realization of the profit or income upon the successful operation of a business does not preclude activities of a taxpayer from

constituting the conduct of a trade or business. This is the clear import of Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963) as evidenced in the following extract from this Court's opinion (Id. at 737):

> "Even conceding that the taxpayer has proved he actively participated in the management of the Jockey Club, nevertheless his activities must still be subjected to the fundamental test: viz., were those activities engendered by a dominant income or profit motive?
>
> ....
>
> "...Even though Hirsch specially requested a finding that he had performed his duties as a member of the executive committee with full expectation of receiving compensation at such time as the track was successful, the Tax Court made no such finding."

The strongest finding sought by Hirsch was that he expected compensation at such time as the track was successful. It seems clear that the decision of this Court would have been different in Hirsch if the Tax Court had made the requested finding and a stipulation had negated the return of an investor as an economic motivation.

Where there are two economic motivations for extensive activities of a taxpayer connected with a corporation, it should be immaterial which of the two motivations dominated when realization of both require the conduct of a trade or business for realization. It would be different if one motivation involved the conduct of a trade or business but the other did not (such as being the anticipated return of an investor). Consequently, it should make no difference whether Petitioner's dominant intent was to receive compensation for services rendered after elimination of the SBA restrictions, or whether

his dominant intent was to realize profit upon the sale of timber to RushMore when permitted by elimination of the SBA restrictions

Nobody devotes extensive time and efforts to the affairs of a corporation unless he is motivated by the expectation of monetary remuneration. With the return of an investor eliminated by stipulation as a motivating economic benefit, Petitioner obviously expected to receive compensation for services rendered and gain from the sale of timber to RushMore as soon as permitted by elimination of the SBA loan restrictions. Both of these motivating economic benefits involved and required the conduct of a trade or business. This should be sufficient to comply with the nonbusiness debt exclusion of Section 166 (d)(2)(A) which merely requires that the loans be created "in connection with" a trade or business of the taxpayer.

CONCLUSION

For the reasons stated herein and in the opening brief for the Petitioners, the decisions of the Tax Court should be reverse

Respectfully submitted,

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CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: December 9, 1966.

William H. Manning

Attorney

CERTIFICATION OF SERVICE

I, WILLIAM H. KINSEY, attorney for appellants, hereby certify that I served three copies of this reply brief on the United States Department of Justice, attorney for the Commissioner of Internal Revenue on the 9th day of December, 1966, by mailing to it three true and correct copies thereof, certified by me as such. I further certify that the three said copies were placed in a sealed envelope addressed to the United States Department of Justice at Washington, D.C.; said sealed envelope was then deposited in the United States Post Office at Portland, Oregon on the day last mentioned with the postage thereon fully paid.

William H. Kinsey

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of Attorneys for Appellants